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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Saudi Arabia's Changed Financial Outlook

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
April 1971

INTELLIGENCE MEMORANDUM

SAUDI ARABIA'S CHANGED FINANCIAL OUTLOOK

Introduction

1. Like other Middle East oil producers, Saudi Arabia will receive markedly larger earnings during the next several years as a result of recent agreements signed with the major petroleum companies. These windfalls will end Saudi Arabia's concern over the strain recently put on its revenues and foreign exchange holdings by outlays on defense, economic development, and foreign aid. Indeed, there will be considerable scope for increased spending on old and new programs and an enormous addition to the country's foreign reserves. This memorandum examines the government's finances before the new oil agreements, the prospective gains in revenues, and the possible magnitude and composition of spending increases.

Discussion

Financial Position in 1970

2. Prior to the recent oil agreements, Saudi officials were deeply concerned with what they saw as a growing financial problem. They were alarmed by three consecutive years of small budget deficits -- the first deficits since 1959 -- and, even more, by the associated 17% drop in the country's traditionally large foreign exchange holdings* from 1967 to

** Foreign exchange holdings include gold and foreign currency held by the Saudi Arabian Monetary Agency (SAMA) and SAMA investments abroad, which generally are highly liquid.*

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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1969. End-of-year reserves had fallen from $944 million to $785 million because of sharply increased imports for development and defense, expanded payments on military debt, and aid to Egypt and Jordan induced by the Arab-Israeli War. Outflows for aid and arms alone increased [redacted] Faced with 25X1

[redacted] 25X1

continued large foreign exchange obligations, the financially conservative Saudis became increasingly apprehensive about their reserves. Although enormous by normal international standards – well above the amount legally required to fully cover the currency – reserves by early 1970 were substantially below the level of one and one-half times annual imports that the Saudis consider desirable.

3. In response to financial difficulties, the government took several steps to strengthen the budget in fiscal year 1970/71.* To bolster revenues, it introduced a personal income tax. On the expenditure side, the government planned to reduce foreign exchange outlays by making half

* *From 2 September 1970 to 21 August 1971. The Saudi "Hijra" fiscal year is shorter than the Gregorian year, hence its Gregorian equivalent changes each year.*

of its Khartoum aid* payments to the UAR and Jordan in oil rather than hard currency. By this move, the Saudis hoped to save about $70 million in cash. In addition, Riyadh pressed Washington for a slight reduction in repayments on arms credits over the next two years. No significant efforts were made, however, to curb military purchases and other defense costs, which were budgeted at 40% of total outlays in FY 1970/71, compared with 28% in FY 1965/66.

4. At the same time, development expenditures were budgeted at $276 million – some $78 million less than in FY 1969/70 and less than half of planned defense spending. Only $22 million was alloted to new developmental projects, compared with an estimated $100 million the year before. This cut, in particular, promised to reduce foreign exchange drawdowns, since most Saudi development projects rely heavily on imported equipment and technical assistance. Some projects such as the Petromin/Occidental sulfur plant and the Riyadh airport were canceled or postponed indefinitely, and work was slowed on the Jidda airport project and on Bedouin housing and job programs at the Faysal Model Settlement Project.

5. Lowered development expenditures caused economic growth to slow in the second half of 1970. Real GNP rose only about 4.5% in 1970 compared with an 8.5% average during the previous decade. The slackening economic tempo was reflected in a one-third reduction in import growth and an immediate improvement in balance of payments. Foreign exchange holdings climbed by $65 million, to about $850 million, by the end of 1970.

The Oil Agreements of 1970-71

6. In late December 1970, Riyadh completed the first of a series of negotiations for increased oil revenues from the foreign producers. Following the successful Libyan accord with foreign oil firms in September 1970, the Saudis obtained an agreement that boosted oil revenues by about 8%. The agreement, retroactive to 14 November 1970, raised posted prices (the prices used in calculating revenues) by 9 cents per barrel for medium and heavy crudes and increased the government's take from 50% to 55% of profits. This agreement alone will provide the government with estimated revenue increases of $145 million in 1971 (including $15 million in retroactive payments for 1970) and about $250 million by 1975 (see Table 2).

* *In September 1967, Saudi Arabia agreed at the Khartoum conference to extend annually $41 million to Jordan and $99 million to Egypt until "the effects of the Israeli aggression are eliminated."*

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Table 2

Saudi Arabian Government Oil Revenues

Million US $

	1970	1971	1972	1973	1974	1975
Oil revenues anticipated under pre-September agreements	1,223	1,456	1,844	2,242	2,484	2,737
Additions from new agreements		622	876	1,191	1,464	1,790
30 December 1970 (retroactive to 14 November 1970)	15 a/	130	167	205	228	252
Late 1970 (Libyan settlement applied to Saudi Tapline shipments) b/	c/	18	20	20	21	21
1 February 1971 (increased Tapline transit fees instigated by Syria)	c/	12	12	13	13	13
Retroactive payments		6	2	1	0	0
14 February 1971 (OPEC - major company agreement on Persian Gulf oil)	c/	362	560	812	1,033	1,305
Saudi share of increased revenue for neutral zone (assuming equal treatment)		34	51	62	75	87
Tripoli agreement (estimated minimum terms) d/	c/	60	64	78	94	112
Estimated new oil revenue schedule	*1,223*	*2,078* *+15 a/* *2,093*	*2,720*	*3,433*	*3,948*	*4,527*

a. To be paid in 1971 as the result of increased payment for 1970 production under terms of the agreement.
b. Tapline was closed from 4 May 1970 until 1 February 1971.
c. Not applicable.
d. Final details as applied to Saudi Arabian oil delivered directly to the Mediterranean are not yet formalized but are expected to approximate the Libyan agreement of April 1971.

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7. Further oil revenue increases occurred in late 1970 and early 1971, when the posted price of Mediterranean oil was increased at Libya's instigation and transit fees were raised on oil passing through the 540-mile Saudi portion of Tapline to the Mediterranean. The increase in posted price will bring Saudi Arabia an extra $18-$21 million annually from Tapline shipments in 1971-75. The oil companies' settlement with Syria in February 1971, providing higher transit fees in exchange for reopening the damaged Tapline pipeline, was immediately extended to Saudi Arabia. Increased transit fees will provide the Saudis with an additional $12-$13 million annually in 1971-75. Saudi Arabia will also receive a cash payment of $9 million to cover retroactive Tapline claims, two-thirds of which will be paid in 1971 and the remainder in small installments through 1973. In all, Saudi Arabia will receive at least $52 million in additional revenues from its oil deliveries to the Mediterranean in 1971.*

8. By far the largest revenue increase will come from the 14 February OPEC** agreement with the major companies, covering oil produced in all the Persian Gulf countries. Under this agreement, Saudi Arabia will receive about $400 million in additional oil revenues in 1971. In addition, the 14 February agreement calls for escalation of revenues each year through 1975, when Saudi Arabia will receive an extra $1.4 billion. Beyond the increases already agreed to, Saudi Arabia should receive gains rising at least from $60 million to $112 million during 1971-75 from other agreements currently being negotiated on Mediterranean oil exports.***

9. Saudi Arabia not only will gain major revenue increases from each barrel of oil produced under their agreements, but also total revenues will be greatly enhanced by rapidly rising output. On the basis of present Aramco plans,† oil production during 1970-75 is expected to grow about 15.5% a year. At present, Aramco is rapidly expanding production facilities in anticipation of increasing output. This planned output growth apparently is based on company estimates that demand, especially in Western Europe and Japan, will continue to rise sharply†† and that Libya will hold

** Includes $16 million for Mediterranean oil obtained under 30 December 1970 agreement.*

*** The Organization of Petroleum Exporting Countries consists of Iran, Iraq, Saudi Arabia, Qatar, Abu Dhabi, Indonesia, Venezuela, Libya, Kuwait, and Algeria, which together account for 90% of the Free World's oil exports.*

**** Agreement already has been reached with Libya, but final arrangements between the oil companies and Saudi Arabia have not been settled.*

† Aramco (Arabian-American Oil Company) produces 94% of Saudi Arabia's oil output. Other companies also plan to raise output significantly.

†† During the past few years, demand for oil in Western Europe has grown by about 10% annually and in Japan by about 18%.

production levels constant as it has in the recent past. It is also influenced by Saudi Arabia's political stability.

Post-Agreement Financial Situation

10. As a result of these agreements and the increase in production, the Saudi financial position has been considerably strengthened for 1971 and has exceptionally favorable prospects through 1975. The added oil revenues will total some $6 billion in 1971-75. Revenues in 1971 from the agreements alone will be about $620 million – or 44% – larger than previously anticipated, and a further gain of 115% in total revenues is in view for the next four years. By 1975, oil revenues will be nearly two-thirds larger than they would have been under the old agreements. Because of the extraordinary rise in oil revenues, the government will be able to carry out existing development and defense programs, to initiate new ones, and to raise Khartoum aid payments to Egypt and Jordan (if desired) – at the same time registering budget surpluses and greatly enlarging foreign exchange holdings.

11. So far, the government seems to have proceeded cautiously with its spending, letting foreign reserves accumulate. Although the economy remains sluggish, indications of a quickening pulse are beginning to appear. Some spending expansion is apparent on the municipal level. The business community expects major increases in government spending under the FY 1971/72 budget, and private investment is beginning to rise, especially in the Eastern Province, in anticipation of heightened economic activity. The expected relaxation of import controls likewise should stimulate the economy. With the oil industry also experiencing rapid expansion, the annual growth of GNP could easily recover by 1972 to the 10% average of the mid-1960s and may go even higher.

Probable Financial Developments

12. A major policy question for the Saudis during the next several years will be what to do with their vastly increased oil revenues. The way is clear for moving ahead decisively with existing economic development programs. The military should be able to get some equipment that it has wanted but has been unable to afford. Increased aid for Egypt, Jordan, and other Arab states will pose no problem. Even so, the prospective spending increases arising from programs suggested in the past by Saudi officials will absorb only a fraction of the additional revenues. At this point, it is difficult to say how much and what kind of additional expenditures will be undertaken during 1971-75.

13. Cut back in recent years because of heavy foreign aid and defense outlays, economic development expenditures probably will be raised at least

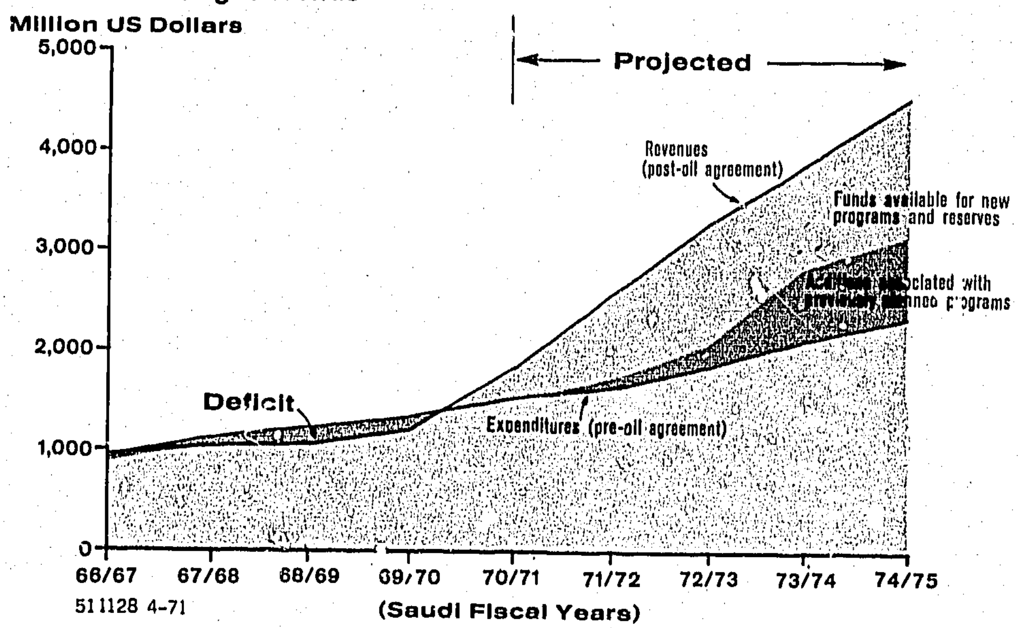
$900 million above the $2.5 billion allocation in the 1971-75 development budget. The resulting amount is the optimum initially sought by Saudi planners. Although planning delays and other administrative problems may hold back spending for a year or two, part of the windfall from the oil revenues probably will be flowing into development projects by the mid-1970s. Saudi Arabia apparently is willing to import the skilled labor (its principal resource limitation) that it needs for accelerated development spending. Most of the additional spending would be used to resume currently suspended and deferred projects and to implement new projects, most likely in transportation and the petrochemical industry.

14. Increases in defense spending beyond the $3.1 billion previously proposed for 1971-75 are nearly inevitable under the strong pressure of special interest groups within and outside the government -- most particularly the hierachy's "5% men" and the foreign munitions salesmen. The $3.1 billion program was conceived during a time of financial difficulties and was designed to meet only so-called "basic military needs." Saudi Arabian officials, however, have expressed keen interest in a considerably expanded military development program that would include a much larger navy, more aircraft, additional tanks [redacted] 25X1
25X1 miscellaneous vehicles, and substantial investment in cantonments, airfields, and modern aircraft maintenance facilities. Should the Saudis opt for the total package, they could spend an additional $100 million or so on the air force and $500 million on the other items. It is doubtful whether the Saudis have the technical capacity to maintain and operate all this equipment, but they may well buy it anyway.

15. Saudi Arabia is likely to be pressed for increased foreign aid in view of its improved foreign exchange situation. Riyadh already has yielded to repeated Jordanian pleas for full payment of Khartoum aid in hard currency. In addition to giving Jordan and possibly Egypt more financial support, the Saudis could also increase aid to Yemen in its campaign against their mutual antagonist, Southern Yemen. Other neighboring Persian Gulf States also might receive more assistance as the Saudis compete with the Shah for influence in this area while the British withdraw. In all, some $200 million in additional aid might be disbursed during 1971-75. Even if Saudi Arabia makes all the additional expenditures outlined above for economic development, defense, and foreign aid in 1971-75, it still will have several billion dollars in oil revenues to spend for new programs or add to reserves (see the chart).

16. Of the aforementioned projected increase in Saudi spending of about $1.7 billion during 1971-75, most will consist of foreign exchange. Because the country must import nearly all its capital goods and because foreigners constitute about half of the industrial labor force,

Estimated Budget Trends



perhaps 60%-70% of all development spending would consist of foreign exchange. Similarly, military expenditures would be largely in foreign exchange as all weaponry must be imported and foreign firms would have to construct the new bases, cantonments, and other facilities. Again, much of the labor for these projects would have to be imported. All foreign aid presumably would consist of foreign exchange. Saudi Arabia will be able, however, to meet all these exchange requirements with ease. Taking into account the new oil agreements, the prospective increase in oil export volume, and projected increase in government expenditure requiring foreign exchange, it still would be in a position to raise foreign exchange reserves from an estimated $850 million in 1970 to a whopping $7.8 billion in 1975 (see Table 3). Even if major new expenditure programs are initiated, the country's finances still promise to be very strong during the next several years. Indeed, Saudi Arabia will be a financial power to be reckoned with.

Table 3

Saudi Arabia: Projection of Major Balance-of-Payments Items

Million US $

	1970	1971	1972	1973	1974	1975
Receipts	*2,220*	*3,360*	*4,430*	*5,640*	*6,530*	*7,540*
Exports, f.o.b. a/	1,960	3,020	4,030	5,160	5,960	6,870
Oil royalties from companies other than Aramco	60	100	120	140	160	180
Pilgrimages, transportation, and other b/	200	240	280	340	410	490
Payments	*2,190*	*2,650*	*3,270*	*3,990*	*4,980*	*5,630*
Imports c/	870	960	1,070	1,270	1,690	1,860
Investment income d/	790	1,060	1,450	1,880	2,190	2,540
Government NIE e/	270	300	320	330	520	550
Tapline expenses f/	10	30	30	40	40	40
Travel b/	90	110	120	140	160	190
Other b/	160	190	280	330	380	450
Foreign exchange surplus	30	710	1,160	1,650	1,550	1,910
Reserves on hand	850	1,560	2,720	4,370	5,920	7,830

a. Derived from estimated petroleum production (oil makes up 95% of exports).
b. Projected from past trends.
c. Imports regressed against government spending (1965-70, R2 of 0.969, students' T value 11.11, average deviation only 2.25%). Future government spending was based on plans plus estimated add-on expenditures.
d. Derived from estimated petroleum production; profits per barrel assumed to be constant.
e. Derived from planned military expenditures plus 70% of estimated add-on expenditures.
f. Derived from terms of new agreement, assuming capacity operation.

Conclusions

17. Revenue increases generated by recent oil pacts between Saudi Arabia and private oil firms will improve Riyadh's financial situation enormously. In contrast to the earlier concern over funding, Saudi officials now face the happy prospect of having considerably larger revenues than they can possibly spend during 1971-75. Expectations are that total government revenues during the period will be about $17 billion, or 55% more than originally anticipated.

18. Considering the new revenue outlook, the Saudis almost certainly will reinvigorate spending on economic development, which recently has been somewhat neglected. More money probably also will be devoted to defense, despite the hefty sums already programmed for the armed forces. Foreign aid increases probably will also absorb some of the additional revenue. No longer will the Saudis be able to claim economic hardship as a reason for cutbacks in the level of hard currency payments to Jordan and the UAR.

19. Even though projected expenditures will require large foreign exchange outlays, this spending will pose no problem for the Saudis. In fact, at the maximum level of spending suggested by past Saudi desires, they will accumulate about $7 billion in additional reserves during 1971-75. With such financial resources available, the only real limit on Saudi spending is its ability to absorb development imports and additional military hardware.

20. As Saudi Arabia's prime supplier, the United States stands to benefit significantly from additional procurement as well as from the trade indirectly generated by increased public investment and accelerated economic growth. Moreover, a large part of the increased reserves – both public and private – probably will be invested in the United States and other Western countries.

21. Although the Saudis may increase spending above the totals projected above, they almost certainly will build reserves to at least $6-$7 billion by 1975. [redacted] these large sums are not likely to be recklessly spent. In the unlikely event a radical regime took over, the Saudi potential for mischief beyond its borders would be very large. Saudi Arabia could finance insurgencies abroad; could suddenly unload large portfolios of European money or securities, causing havoc in international 25X6

financial markets; or could demand conversion of large amounts of foreign exchange into gold in the United States. Such actions would be especially serious if they were coordinated with other rich Arab states, such as Libya, which is expected to have reserves of its own of perhaps $6 billion by 1973.